

pricing at the expense of consumers. Continuing this protectionist policy would benefit only the long distance providers, a protection they appear to be counting on. Thus, AT&T's new CEO hopes for an additional 18-24 months of regulatory protection so AT&T "can get our act together."³¹ Until the Commission's application of Section 271 matches Congress's intent, BOC entry into long distance cannot legitimately be assumed to occur in time to prevent the competitive harm of a WorldCom acquisition of MCI. Thus, the Commission's approach of simply assuming BOC participation in the long distance market, an approach it used in analyzing the Bell Atlantic/NYNEX merger, runs counter to the facts and will only work harm to consumers if adopted here.³²

B. BOC Entry Into Long Distance, Without Artificial Regulatory Handicaps Would Alleviate The Anticompetitive Effects Of The Acquisition

First, although BOCs would have to enter the long distance business as resellers of wholesale services, they would be the sort of large, sophisticated buyers that are capable of successfully combating anticompetitive price increases. The antitrust agencies recognize that sophisticated buyers can effectively destabilize cartels and circumvent anticompetitive price increases. Thus, BOC entry is likely to protect the market from wholesale price increases for long distance voice and Internet services.

Second, BOCs are uniquely positioned to break up the cartel-like pricing behavior that WorldCom's acquisition of MCI will facilitate. The Commission recognizes that

³¹ Report of Janney Montgomery Scott Inc. (prepared by Anna Marie Kovacs, Ph.D.), Meeting with AT&T's Top Management, December 19, 1997 at 1, attached as Appendix D.

³² *Bell Atlantic Order* at ¶ 98.

BOCs enter the long distance market with no market share and thus little incentive to participate in any collusive pricing. Instead, the Commission has found that the BOCs have “the incentive to price competitively (that is, to undercut prices that were above the competitive level) in order to win customers... Thus, [BOCs are] well situated to disrupt any coordinated pricing that might occur.”³³ The BOCs also have affirmative incentives to lower long distance prices, because increased interLATA usage will increase usage of the BOCs local network as well. Thus, the Commission has found that the BOCs are likely to function as pro-consumer “maverick” firms in the long distance market, not as members of the incumbent group.³⁴

Indeed, SNET’s entry into the long distance business in Connecticut has broken the Big 3’s cartel-like behavior and substantially reduced industry concentration, to the great benefit of every Connecticut long distance user. Taking customers principally from the largest long distance firm, SNET has gained significant market share. By reducing AT&T’s market share, SNET has deconcentrated the industry.³⁵

SNET’s entry has newly invigorated long distance competition in Connecticut. On average, SNET’s residential long distance rates have been 17-18 percent lower than AT&T’s. Hausman Aff. ¶¶ 12-19. Savings due to SNET’s plans have especially benefited low-volume callers. However, as other IXCs have had to begin to really compete for

³³ *Bell Atlantic Order* at ¶ 123.

³⁴ *Id.*

³⁵ For example, the *Long Distance Market Share Report* reports residential market shares on a state-by-state basis for 1996. In Connecticut, AT&T’s market share was 44%, roughly 25 percentage points lower than its average share. Even assuming all this share loss went to SNET, this would translate into an HHI reduction in the range of two to three thousand points.

business, the benefits from SNET's entry have been expanding. Thus, IXC have extended the price cutting to intraLATA toll services. Hausman Aff. ¶¶ 10, n.13, 22.

Like SNET, the BOCs are well positioned to inject a potent new competitive force into the long distance market, a force sufficient to counterbalance the ill-effects of the WorldCom/MCI acquisition. Unlike other potential entrants and small long distance resellers, BOC name recognition and reputation among in-region customers is on par with those of the Big 3 IXCs. In particular, the BOCs have pronounced marketing strengths among the residential segment that is likely to suffer disproportionately from the acquisition's facilitation of continued lock-step pricing. However, BOCs are currently barred from competing for long distance customers throughout their regions, and are subject to a substantial regulatory handicap if they eventually can begin to compete.³⁶

CONCLUSION

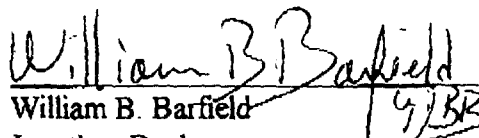
Given the current long distance market structure and the increased concentration that a WorldCom acquisition of MCI would cause, the proposed acquisition threatens to bring about competitive harm and run counter to the public interest. The proposed deal poses particularly grave risks for residential customers. The BOCs represent a potent new competitive force that could be brought to bear in the long distance market. BOC entry would both prevent price increases for wholesale long distance and Internet transport service and prevent the continuation of the lock-step consumer price increases that the

³⁶ See, e.g., *First Report and Order and Further Notice of Proposed Rulemaking*, In the Matter of Implementation of the Non-Accounting Safeguards of Sections 271 and 272 of the Communications Act of 1934, as amended, CC Dkt. No. 96-149 (rel. Dec. 24, 1996).

acquisition will facilitate. Further, taking down the artificial barrier to BOC entry would begin to restore the incentives to create networks that bring the benefits to residential consumers that are currently reserved to the business market. Thus, conditioning approval of WorldCom's acquisition of MCI on broad-scale BOC entry into long distance competition would create a sufficient measure of market-based protection for consumers to allow the acquisition to proceed in the public interest.

Respectfully submitted,

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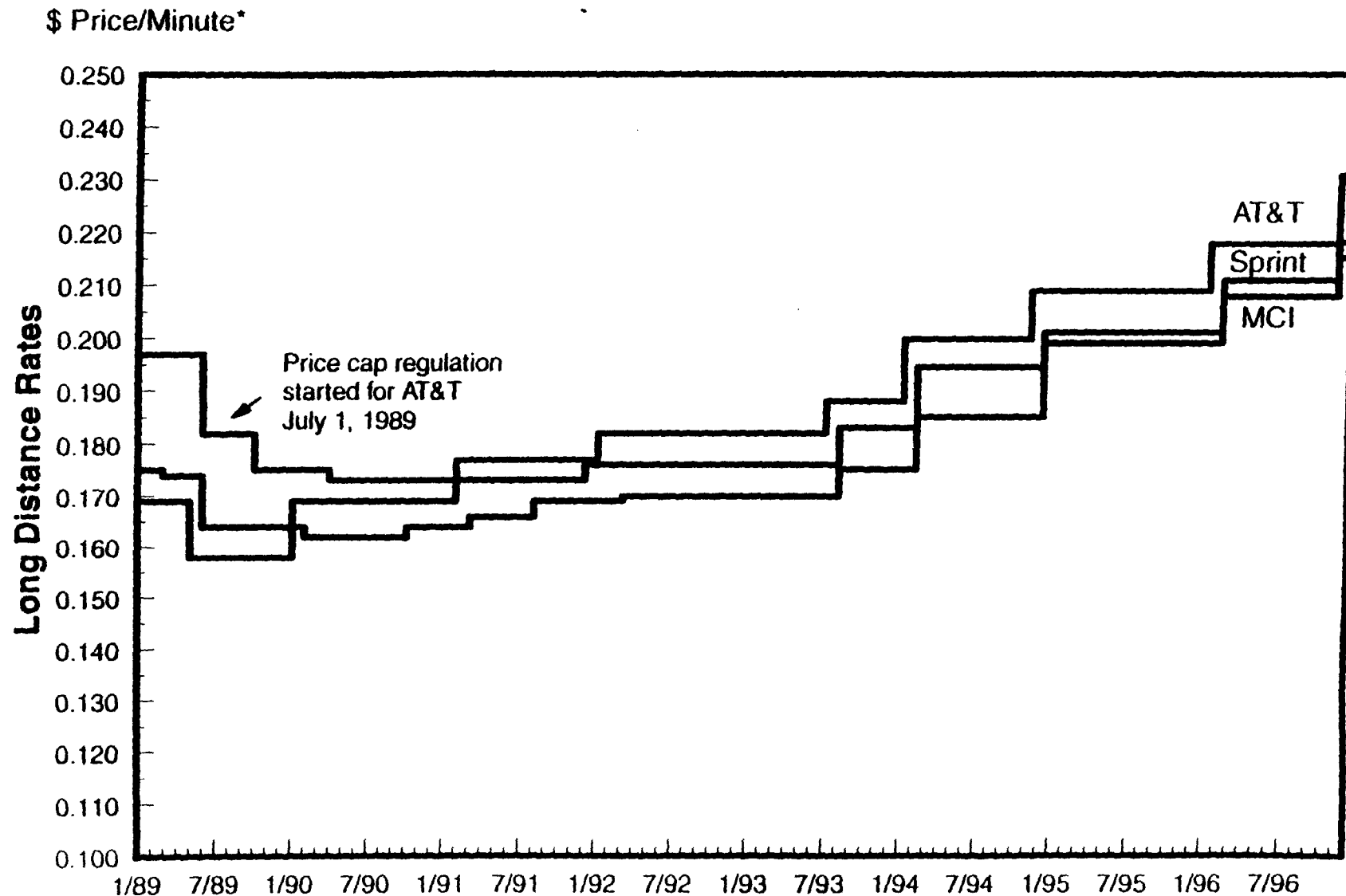
APPENDIX A

1997 Bill Harvesting Residential Long Distance Market Shares

Revenue Shares (excluding local company provided toll service)			
Company	Total Toll Revenue	Pre- Acquisition Share	Post Acquisition Share
AT&T	\$ 212,278.31	60.53%	60.53%
MCI	\$ 55,528.05	15.83%	-----
Sprint	\$ 21,499.55	6.13%	6.13%
Other	\$ 61,378.76	17.50%	17.50%
Total	\$ 350,684.67	100.00%	84.17%

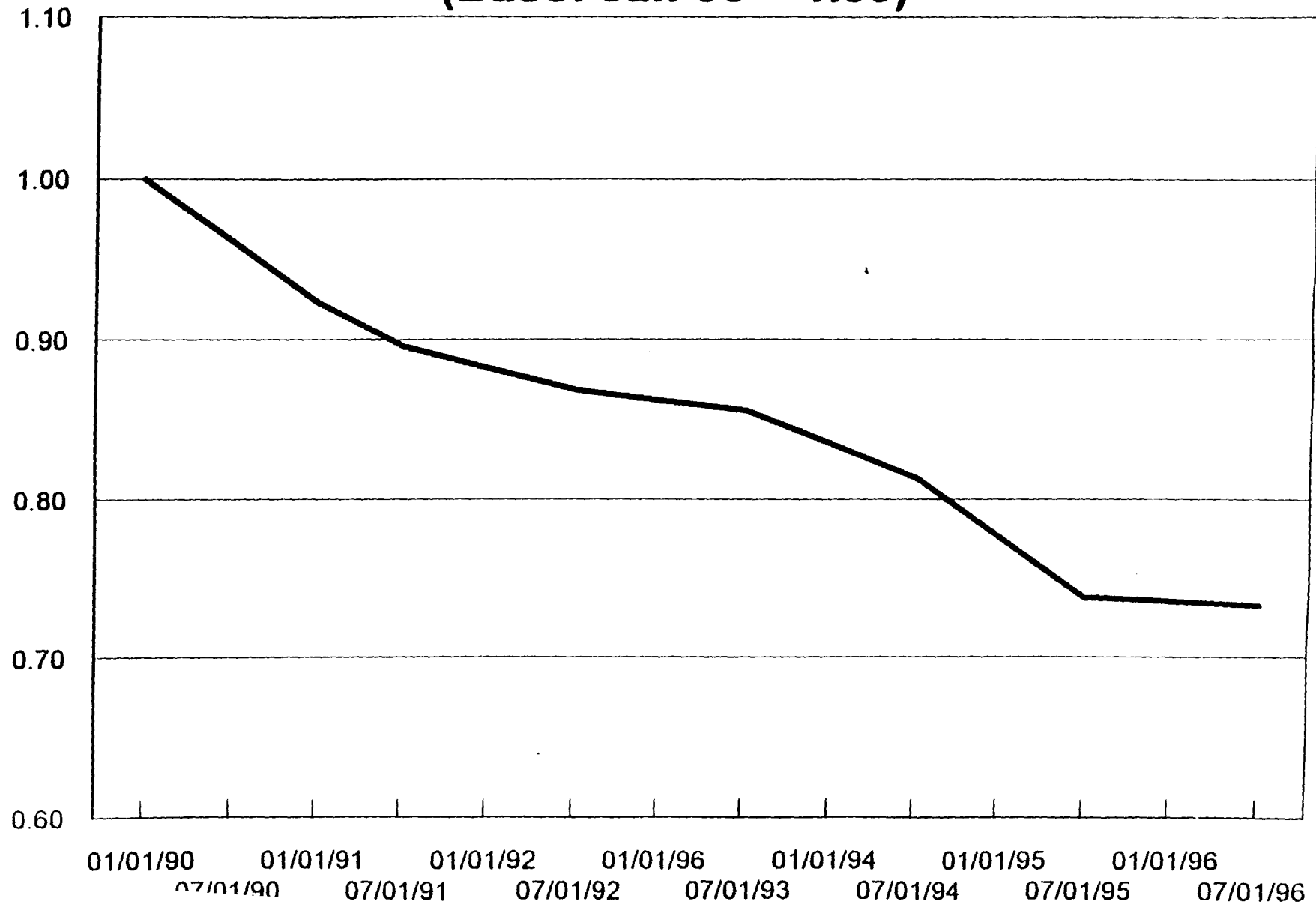
Source: PNR and Associates, Inc. - 1997 Bill Harvesting

Trends in Long Distance Rates



* Long distance rates based on the average price per minute for basic service.

Access Charges Have Been Decreasing Over the Years (Base: Jan-90 = 1.00)



**BELLSOUTH'S PROSPECTS FOR SUCCESS IN THE
INTERLATA MARKET**

Declaration on Behalf of BellSouth

by

Richard L. Schmalehsee

August 18, 1997

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DECLARATION OF RICHARD L. SCHMALENSEE

I. QUALIFICATIONS

1. My name is Richard L. Schmalensee. I am the Gordon Y Billard Professor of Economics and Management at the Massachusetts Institute of Technology (MIT), Deputy Dean of MIT's Sloan School of Management, and a Special Consultant to National Economic Research Associates, Inc. (NERA). My business address is One Main Street, Cambridge, Massachusetts 02142.

2. I served as a Member of President Bush's Council of Economic Advisers, where I had primary responsibility for domestic and regulatory policy, including telecommunications policy. I have done extensive research on aspects of industrial organization and of antitrust and regulatory policy, and I teach graduate courses in industrial organization, its applications to management decisions, government regulation, and government/business relations. I am the author of *The Economics of Advertising* and *The Control of Natural Monopolies* and co-author of *Markets for Power*. I am the co-editor of the *Handbook of Industrial Organization* and founding editor of the MIT Press *Regulation of Economic Activity* monograph series. I have published over 60 articles and have served on editorial boards of several professional journals. I am a Fellow of the Econometric Society and of the American Academy of Arts and Sciences, and I have served on the Executive Committee of the American Economic Association. I have testified before federal and state courts, Congressional committees, and the Federal Trade Commission. I have served as a consultant on regulatory and competitive issues to numerous organizations in the United States and abroad, including the U.S. Federal Trade Commission and the Antitrust Division of the U.S. Department of Justice. I received S.B. and Ph.D. degrees in economics from MIT. A copy of my resume is in the appendix.

II. INTRODUCTION

3. Counsel for BellSouth has asked me to assess the following:

- the extent to which consumers have or have not benefited from long distance competition in recent years;
- BellSouth's credibility as an entrant into the interexchange services market in its "home region;" and
- the effect on interexchange competition of having carrier access charges set above costs.

This affidavit reports on my assessments.

4. Why are the assessments on which I report here useful? As discussed below, I find that long distance rates paid by consumers have increased in recent years even though interexchange carriers' costs have fallen. This finding is inconsistent with effective competition among the interexchange carriers for the consumer segment. Based on the currently inadequate competition in the interexchange market, one would expect that BellSouth's entry would increase competition in that market. The results would tend to be lower prices, new and better service offerings, increased customer satisfaction, and perhaps more rapid technological improvements. The ultimate beneficiaries of these improvements would be the public which buys interexchange services. For all these improvements to follow, BellSouth should have reasonable prospects for success in the interexchange market; if, to the contrary, its entry were not credible, then its entry is unlikely to have a significant effect on that market. Thus the relevance of my investigation on BellSouth's prospects. The inadequate competition for the consumer segment and the credibility of BellSouth's success supports the public interest benefits of its being allowed to enter the interexchange market. At the same time, the inadequate competition in the market enhances the likelihood of BellSouth's success.

5. Let me be clear about what this report is and is not. I assess BellSouth's strengths and weaknesses regarding its entry into the interexchange market. Does this mean I can predict with confidence that BellSouth's entry will be profitable for BellSouth's stockholders? No. Market entry is almost always a risky proposition. I am certainly not issuing a buy or sell

recommendation to BellSouth's stockholders. Rather, using publicly available information, I assess the plausibility—not probability—of BellSouth's success.

6. Briefly, these are my findings:

- Competition for the consumer segment of the interexchange market is inadequate, as demonstrated by three types of evidence:
 - ◆ The recent pattern of changes in market shares for the interexchange carriers is fully consistent with tacit price coordination among the Big Three interexchange carriers—AT&T, MCI, and Sprint—which are trying to maintain high retail profit margins.
 - ◆ AT&T has increased its interstate basic rates by 22 percent since 1993 even though average access charges declined by nine percent and its other costs also declined.¹ Most of AT&T's customers face these basic rates. Even if one accounts for increasing subscriptions to discount calling plans, the average consumer still was paying higher rates in 1996 than in 1993. The new flat rate-per-minute plans do not change that conclusion.
 - ◆ AT&T's own data show that the rates paid by most of its residence customers are well above costs.

I present the above evidence in Section III.

- To evaluate BellSouth's credibility as an entrant into the interexchange market, a useful approach is to compare BellSouth's strengths not only with the strengths of the three largest interexchange carriers but also with those of a hypothetical *de novo* entrant into the interexchange market and with those of existing small interexchange carriers. I explain this approach in Section IV.

¹ My analysis does not account for the interexchange carriers' rate reductions in mid-1997. These reductions are part of a deal struck with the FCC in exchange for access charge reductions, for which I also have not accounted.

- Particularly in the long run, BellSouth would have low incremental costs of providing interexchange service, as I explain in Section V.
- BellSouth's reputation with the customers in its region is excellent, so BellSouth's marketing position would be good. Its strength would be particularly important for the low-usage customers whom other carriers tend to neglect, so BellSouth can increase competitiveness in the market for that segment in a way that other carriers have not. Section VI covers this topic.
- The incumbent interexchange carriers have argued that interexchange entry by a local exchange carrier would harm competition as long as carrier access charges are above costs. As discussed in Section VII, I find that this argument has no merit.
- The combination of low incremental costs and a good marketing position make the company a credible competitor in the interexchange market, as Section VIII explains. Although BellSouth has competitive strengths, however, these strengths do not appear great enough for the company to dominate the interexchange market.

My conclusion is that BellSouth's entry would increase the competitiveness of the interexchange market, particularly for the consumer segment.

III. INADEQUATE COMPETITION FOR THE CONSUMER MARKET

7. Although large business customers have benefited from competition in the interexchange market, competition for the consumer market is inadequate. I present three types of supporting evidence for this conclusion.² First, the pattern of changes in long distance market shares is consistent with high retail profit margins. Second, AT&T has increased rates for the consumer segment for the past several years in spite of decreasing costs. Third, AT&T's rates

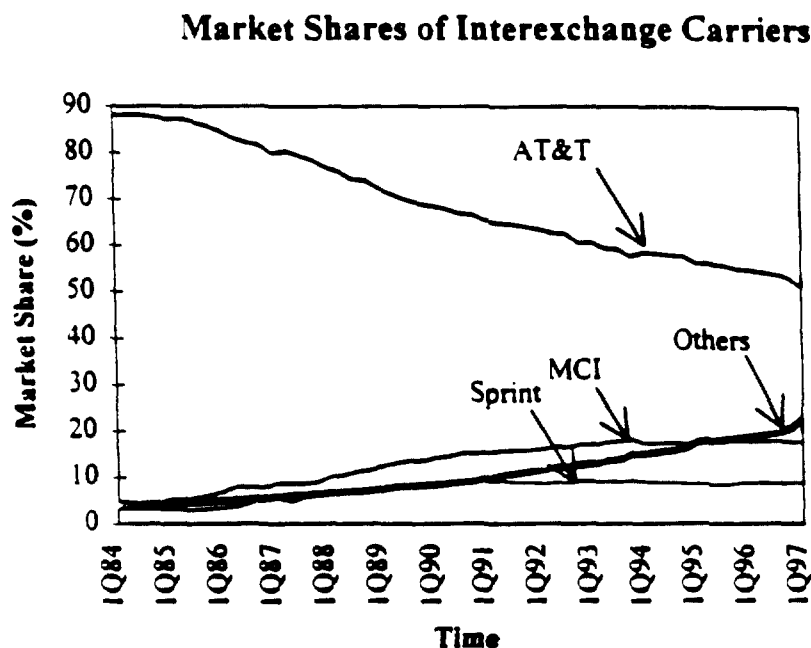
² I have previously written about the additional evidence that the Big Three have consistently increased their rates in lock step. See Paul S. Brandon and Richard L. Schmalensee, "The Benefits of Releasing the Bell Companies from the Interexchange Restrictions," *Managerial and Decision Economics*, Vol. 16, No. 4 (July-August, 1995), pp. 349-364, specifically p. 352.

are above costs for most of its residence customers. I explain each of those types of evidence below.

A. Market Share Changes Indicate High Retail Profit Margins

8. The Federal Communications Commission (FCC) periodically reports on interexchange carrier market shares. It measures market share using access minutes, presubscribed lines, and toll revenues. For present purposes, toll revenues are a useful summary measure. Figure 1 below shows the toll revenue market shares for the Big Three interexchange carriers and all other carriers combined.³

Figure 1



Since the first quarter of 1984, AT&T's market share has declined every year. However, Sprint's share appears to have reached a plateau in 1991, and MCI's share reached a plateau in

³ Joe Bender, Industry Analysis Division, Common Carrier Bureau, Federal Communications Commission, "Long Distance Market Shares" (July, 1997), Table 8. The FCC report shows WorldCom separately, whereas, to simplify the presentation, Figure 2 combines WorldCom with all other carriers. The lesson from the data would not be changed if WorldCom were shown separately.

1993. The revenue share of carriers other than the Big Three increased every year, and it has not hit a plateau. This pattern of growth by the smallest carriers is consistent with tacit price coordination among the Big Three carriers, or at least with a tight-knit oligopoly: the Big Three appear willing to accept a gradually eroding market share—in the case of AT&T—or stable market shares—in the case of MCI and Sprint—in exchange for the higher profits they can earn currently relative to what they could earn if they were to compete more aggressively. Almost all the carriers other than the Big Three are resellers. The Big Three are maintaining and even increasing high profit margins for retail long distance rates relative to wholesale rates, and it is this margin that has been stimulating the growth of smaller carriers.⁴

B. AT&T Has Increased Rates for the Consumer Segment

9. AT&T raised its interstate basic rates by 22 percent between 1993 and 1996,⁵ even though average access charges for the interexchange carriers fell by nine percent in that period.⁶ AT&T has also been reducing its costs other than access: according to data supplied by AT&T to the FCC, its annual reports to stockholders, and statements by Professor Robert Hall, the productivity of AT&T and the other interexchange carriers has been increasing. In its price cap filing before the FCC, AT&T reported data showing that, from 1985 to 1991, it reduced its capital costs relative to output by 2.1 percent per year, and it reduced its non-capital costs by

⁴ WorldCom has network capacity of its own, and it, too, has been increasing its market share. (Joe Bender, "Long Distance Market Shares," *op. cit.* This growth suggests that the wholesale prices of the Big Three might also be above cost.

⁵ AT&T raised basic residence rates by an average of 6.3 percent in January 1994 ("AT&T Proposes \$750 Million Rate Hike, New Calling Plan Aimed at High-Volume Residential Users," *Telecommunications Reports*, January 3, 1994); 3.7 percent in December 1994 ("AT&T and Rivals Boost Rates Further," *Wall Street Journal*, November 29, 1994, p. A3); 4.3 percent in February 1996 ("AT&T to Raise Basic Prices an Average 40c a Month," *Bloomberg News Services*, February 16, 1996. See also "AT&T Increases Basic Rates, Extends Discount Plans," *Telecommunications Reports*, February 26, 1996, p. 27); and 5.9 percent in December 1996 ("AT&T Follows MCI, Sprint with Long Distance Rate Increases," *Telecommunications Reports*, December 2, 1996). The cumulative increase is $1.063 \times 1.037 \times 1.043 \times 1.059 - 1 = 0.22$. AT&T also increased rates between 1991 and 1993, but it accelerated the rate of increases after 1993.

⁶ From 1993 to 1996, average switched access charges fell from 6.66 cents to 6.04 cents per conversation minute. *FCC Monitoring Report*, Table 5.11, May 1996, p. 474.

7.3 percent per year.⁷ More recently, AT&T reported that it continued to improve productivity: "Total cost of telecommunications services declined [in 1993 and 1994] despite higher volumes, *in part* because of reduced prices for connecting customers through local networks. *In addition, we improved our efficiency in network operations, engineering and operator services.* With lower costs and higher revenues, the gross margin percentage rose to 41.8% in 1994 from 39.0% in 1993 and 37.2% in 1992."⁸ If the long distance market were truly competitive, the incumbent interexchange carriers would have passed through to consumers the above reductions in both access and nonaccess costs.

10. The increases in interstate basic rates affected most of AT&T's customers. For each state in BellSouth's territory, Table 1 shows the percentage of AT&T residence customers who faced basic rates for interstate toll in 1996.⁹ These customers include two groups—those who subscribe to no calling plan and those who subscribe to a calling plan but whose toll usage is insufficient to generate any discount.

Table 1
Percentage of AT&T Residence Customers Facing Basic Rates for Interstate Toll in 1996

State	Percentage of Households
Alabama	67%
Florida	59%
Georgia	55%
Kentucky	70%
Louisiana	67%
Mississippi	67%
North Carolina	60%
South Carolina	70%
Tennessee	66%
Total	62%

⁷ R. Schmalensee and J. Rohlf, "Productivity Gains Resulting from Interstate Price Caps for AT&T," report filed by AT&T in CC Docket No. 92-134, July 1992. The cost reductions I report here are in real terms.

⁸ AT&T 1994 Annual Report, p. 24.

⁹ Based on calculations using PNR and Associates' "Bill Harvesting III" database, Release 2 (May 1996).

As these data show, in every BellSouth state more than half of AT&T's residence customers face interstate basic rates and thus have seen rate increases of 22 percent since 1993. For all BellSouth states combined, the percentage facing basic rates is 62 percent.

11. Some customers do subscribe to discount calling plans and pay less than basic rates. It is even true that the percentage of AT&T's customers subscribing to calling plans has been increasing, so the average percentage discount received by residence customers as a whole has been increasing. But, even taking account of the increase in the average discount, the rates paid by the average residence customer have increased since 1993. For all BellSouth states combined, the average discount off basic rates on a dollar of residence AT&T toll calls in 1996 was only 15.6 percent.¹⁰ To construct an extreme hypothetical illustration, suppose that *no* AT&T customer had a discount calling plan in 1993. Even under such an extreme assumption, AT&T residence customers in BellSouth states would still have experienced an average increase in rates of three percent.¹¹ Contrary to that extreme illustration, however, according to Yankee Group national surveys, 20.5 percent of AT&T households had a calling plan in 1993,¹² and the percentage had increased to only 38.4 percent in 1996.¹³ A plausible estimate of the increase in AT&T's average interstate rates for AT&T residence customers in BellSouth states, *accounting for discounts*, is about 12 percent from 1993 to 1996.¹⁴ Yet during the period, as I mention above, AT&T's costs declined.

¹⁰ *Ibid.*

¹¹ $1.22 \times (1 - 0.156) = 1.030$.

¹² The Yankee Group, "The Technologically Advanced Family Tracking Study—1993," Table 327.

¹³ The Yankee Group, "1996 TAF Survey: Implications for Convergence," December, 1996, Table 307, p. 717.

¹⁴ This estimate is based on the Yankee Group data on percent of customers with discount plans, and assumes that the average discount is proportional to the percentage of customers receiving discounts. (Based on data from PNR and Associates' Bill Harvesting III database, Release 2.) Even if the best available discounts might have increased over the period, new plan customers tend to receive lower discounts than previous ones, because the ones who sign up early are the ones for whom the plans are most advantageous.

C. The New One-Rate Calling Plans Do Not Change the Results

12. The interexchange carriers have introduced calling plans with flat per-minute rates: an example is AT&T's One Rate plan, which charges 15 cents per minute regardless of distance or time of day. These new plans do not change the conclusion that AT&T has increased rates since 1993. To evaluate the potential effect of AT&T's One Rate plan, I first calculated the price that an average AT&T customer in the BellSouth states would have paid in December 1996 for domestic direct dialed calls at AT&T's basic interstate rates.¹⁵ The average rate was about 18.9 cents per minute. Since 15 cents under the One Rate plan is lower than 18.9 cents, the One Rate plan might be attractive to many residence consumers today who are paying basic rates.

13. The One Rate plan would not benefit all residence customers, however. The plan would not be attractive for customers who make most of their calls on weekends or at night. (As discussed below, Professor Robert Hall acknowledges that residence customers make most of their calls in off-peak periods.) The new plan also would not benefit many customers who are already on another plan. For instance, a True Reach customer who already receives a 25 percent discount would typically pay more under the One Rate plan.

14. My main point about AT&T's One Rate plan is this: the only reason that many consumers might find the One Rate plan attractive today is that *AT&T has substantially raised its basic rates over the last several years*. If instead AT&T had merely passed through its savings in access charges—even ignoring its other cost savings—then its 15-cents-per-minute One Rate plan would be unattractive in comparison. As I have said, AT&T raised its basic rates by about 22 percent between 1993 and 1996. Suppose that AT&T had not increased its rates. Then today the average basic rate for direct-dialed calls would be only about 15.5 cents minute.¹⁶ If AT&T had passed through the industry-average decrease in access charges of 0.6

¹⁵ Based on 1995 calling data from PNR and Associates' "Bill Harvesting II" database.

¹⁶ $\$1.89/1.22 = \0.155 . I implicitly assume that AT&T increased rates for direct-dialed calls by about the same percentage as for other calls.

cents since 1993.¹⁷ then the average basic direct-dialed rate today would be 14.9 cents a minute. If AT&T had also passed through its other cost reductions, today's basic rates would be even lower. In summary, net of access charges AT&T increased basic rates for direct-dialed calls by about 4 cents, or 45 percent.¹⁸ If instead it had passed through its cost decreases, as would have happened in a truly competitive market, AT&T's touted One Rate plan would be a nonstarter. Thus, in introducing its One Rate plan, AT&T has nothing to brag about. Still, its pricing plans have been clever: (1) It was able to collect increasing excess profits from its residence customers for several years. (2) Just in time for the Section 271 proceedings, it has now introduced its One Rate plan, which it can hope might sway some opinions during the proceedings. (3) And it can be confident that, in spite of making the One Rate plan available, many customers will continue paying basic rates for quite a while.¹⁹ The combination of rising basic rates and optional calling plans effectively exploits many customers' lack of information and inertia. With their pricing, the interexchange carriers segment the market, separating the active "bargain-hunters" from the "victims."

D. Interexchange Rates Are Above Costs

15. In an FCC proceeding, AT&T asserted that the costs of serving customers with bills less than \$3 per month exceed the revenues received from them; *i.e.*, AT&T's break-even point is \$3 per month.²⁰ The incumbent carriers sometimes justify their increases in basic rates by claiming that they must cover the costs of serving customers with low usage. This explanation for increasing rates, even if true, is clearly inadequate. It does not explain why AT&T should have increased rates for two groups: (1) the 22 percent of its customers with monthly bills

¹⁷ *FCC Monitoring Report, op. cit.*

¹⁸ $18.9 - 15.5 + 0.6 = 4.0$. $(18.9 - 6.04) / (15.5 - 6.66) - 1 = 0.45$.

¹⁹ As reported above, between 1992 and 1996, the calling plan subscription rate of AT&T residence customers increased from 20.5 percent to 38.4 percent—only 4.5 percentage points per year. Yankee Group TAF surveys, *op. cit.*

²⁰ Letter from C. L. Ward, AT&T, to W. F. Caton, FCC, Re: *Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Non-Dominant Carrier*, filed in CC Docket No. 79-252 (April 24, 1995).

above \$3 but less than \$10,²¹ the threshold for eligibility for its True USA and True Reach calling plans; and (2) the many residence customers who have bills exceeding \$10 per month who did not benefit from calling plans. If \$3 per month of billings is the break-even point, then, at a minimum, AT&T is making supracompetitive profits from those two groups, and it increased its profits as it increased basic rates. One can, moreover, derive an alternative estimate of the break-even point using data provided by Professor Robert Hall. Data from an affidavit he filed in FCC proceedings on SBC's Section 271 application for Oklahoma imply that the break-even point is actually lower than AT&T's claim. Specifically, his figures imply a break-even point of \$2.08; thus, even more than 22 percent of AT&T's customers probably have bills between \$10.00 and the break-even point.²²

16. Further, Professor Hall's own data confirm that AT&T is making supracompetitive profits from its residence customers—even those with calling plans. First, Professor Hall estimates that long distance service costs are a little below ten cents per minute.²³ He uses the approach of estimating costs by finding "the best available price . . . for offices and homes," which some resellers offer. I interpret that estimate as an upper bound, since a reseller which can profitably sell at that price might pay more than the incremental costs of one of the facilities-based carriers for network transmission and switching. I also assume that that cost applies to direct-dialed domestic calls, not operator service or international calls. Furthermore, as Professor Hall himself points out, the network cost of off-peak calls is lower than that of peak calls, and residence customers make most of their calls in off-peak periods. Thus, the cost for residence customers might be less than ten cents per minute. Second, Professor Hall does

²¹ Letter from C. L. Ward, AT&T, to W. F. Caton, FCC, Re: *Ex Parte Presentation in Support of AT&T's Motion for Reclassification as a Nondominant Carrier* (March 9, 1995).

²² Affidavit of Robert Hall on behalf of MCI in *Application of SBC Communications Inc., Southwestern Bell Telephone Company, and Southwestern Bell Communications Services, Inc., for Provision of In-Region, InterLATA Services in Oklahoma*, CC Docket 97-121. Professor Hall claims that an additional customer costs \$.98. (Hall at ¶ 42) As discussed below, he also estimates that the incremental cost of usage is 10 cents a minute. (Hall at ¶ 36) (To be conservative, here I assume that this 10-cent cost does not double count the per-customer costs of \$.98.) Although he is not clear on the point, I tentatively infer that this cost applies to direct-dialed calls. The average basic rate for direct-dialed calls is 18.9 cents. Then Professor Hall's figures imply that the break-even point would be a monthly bill of about \$2.08 ($0.189 \times 0.98 / [0.189 - 0.10]$).

²³ Affidavit by Professor Robert Hall, *op. cit.*, at ¶ 36.

not challenge the estimate of Drs. Kahn and Tardiff that AT&T's average revenue per minute from residence customers for direct-dialed calls is about 18 cents. Therefore, Professor Hall's own cost estimate would imply that AT&T's profit margin for the average residence customer is about 8 cents per minute, and it has been increasing as AT&T has raised rates.

17. Even AT&T residence calling plan customers are paying rates above costs. The maximum standard discount available through AT&T's True Reach plan is 25 percent. So a typical high-volume True Reach customer would pay about 14.2 cents a minute,²⁴ which exceeds Professor Hall's estimated cost of 10 cents a minute. Subscribers to AT&T's new 15-cent One Rate plan must also be paying rates substantially higher than costs.

IV. AN ANALYTICAL APPROACH TO ASSESSING BELL SOUTH'S ENTRY PROSPECTS

18. Recall my discussion above that the FCC's data show that the market share of smaller interexchange carriers has been growing relative to that of the Big Three. This fact suggests that there is a promising market opportunity for small or perhaps even newly-entering carriers. If, to the contrary, the market share of the small carriers were declining, I would be more concerned about BellSouth's likely prospects in the interexchange market.

19. The FCC data are qualitatively consistent with another study by a market survey company called Odyssey. It reports the percentage of U.S. households using each long distance carrier.²⁵

²⁴ $\$0.189 \times (1 - .25)$.

²⁵ Sandra Guy, "Reselling Upends LXC's Marketing Plan," *Telephony* (July 1, 1996), p. 20.

Table 2
Market Shares of Interexchange Carriers
(Percentage of U.S. Households)

Carrier	4Q94	1Q95	4Q95	1Q96
AT&T	74	71	66	65
MCI	11	12	13	12
Sprint	4	4	4	5
Other	—	7	12	12
Don't know/no answer	11	6	5	6

20. According to these data, too, while AT&T's market share is declining, MCI's and Sprint's shares are stable, and the other carriers' share is growing. The study also reports that "consumers who rated AT&T's image as 'very good' fell from 68% two years ago to 59% in the latest survey."²⁶ Emphasizing the growing market share of resellers, the article states, "The findings point to a potentially lucrative field for the Bell companies, which can succeed in their foray into long-distance by becoming 'super resellers,'"²⁷ according to a separate report by the Yankee Group.

21. Based on its assessment of the attractiveness of the RBOCs and turnover of customers of the interexchange carriers, a report by the Yankee Group estimates that the RBOCs in the aggregate will achieve about a 10 to 15 percent share of the national interLATA household market 18 months after entering the market.²⁸ If BellSouth's success were equal to that of the average RBOC and if it were to focus on customers in its home region, then its share of the household market within its region would also equal between 10 to 15 percent. Since it has about 14 percent of RBOC access lines, then, based on the Yankee Group predictions, its share of the national interLATA household market would be about 1.7 to 2.6 percent.

²⁶ *Ibid.*

²⁷ *Ibid.*

²⁸ The Yankee Group, "IXCs versus RBOCs: The Battle of the Century" (December, 1995), p. 24. This report also estimates that the RBOCs will lose about the same percentage of their local market in the same period of time (p. 26).

22. I should point out that these data are suggestive, not definitive. Although insufficient by themselves, the combination of these data and the other information discussed in the sections below more convincingly portray the picture of BellSouth's entry prospects.

23. The supracompetitive profits and pricing discipline of the Big Three carriers would have to diminish in the face of the market entry of BellSouth and other new entrants. From the point of view of customers, the lower prices resulting from such a breakdown in profit margins and pricing discipline would be good news.

24. Already, there are signs of downward pressure on prices due to RBOC interLATA entry; as one article puts it, "Further evidence of a changing long-distance market is apparent in BellSouth's recent agreement to buy wholesale long-distance transport from AT&T at what the RHC called 'the low end' of the 1¢- to 2¢-per-minute range. The agreement signifies a potentially radical change in consumer and business services pricing and the possibility of a real price war, said Robert Rich, vice president of telecommunications research at The Yankee Group."²⁹ These pressures could only increase when BellSouth and the other RBOCs enter the in-region interLATA market.

25. Now we come to my main point. We have seen that smaller carriers are gradually gaining market share. Still, so far their gains have been insufficient to break down the pricing discipline of the Big Three carriers.³⁰ I explain in the sections below that BellSouth has several strengths. These strengths might be sufficient for a more effective challenge to the Big Three than the existing smaller carriers have presented, particularly for low-usage customers who have faced a succession of price increases in recent years.

²⁹ *Ibid.* At the time of the contract, BellSouth could only use the wholesale transport for cellular and out-of-region resale activities. Similarly, Bell Atlantic reportedly negotiated bulk transport at 1.5 cents per minute. "Bell Atlantic Adopts Retail Long Distance Strategy," *Telecommunications Reports* (September 23, 1996).

³⁰ See, e.g., P. W. MacAvoy, "Tacit Collusion under Regulation in the Pricing of Interstate Long-Distance Telephone Services," *Journal of Economics and Management Strategy*, v. 4, No. 2 (Summer 1995), pp. 247-185; also see W. E. Taylor and J. D. Zona, "An Analysis of the State of Competition in Long Distance Telephone Markets," Study Attached to Ex Parte Comments Examining the Competition of Interstate Long Distance Telephone Markets, FCC CC Docket No. 79-252 (April, 1995).

26. Let me expand on that point about low-usage customers. That market segment—predominantly residence customers—is the largest group of customers, yet it is neglected in the competition among interexchange carriers. I report above that, in 1996, 62 percent of AT&T's residence long distance customers in the BellSouth states faced full, undiscounted toll rates.³¹ Also consider Table 3 below. It shows data for 1996 from the FCC's market share report and a calculation I have made from the data. The FCC report shows each major interexchange carrier's number of presubscribed lines and total operating revenues. From the FCC report, I show results for the ten largest interexchange carriers for which the FCC reports data on both presubscribed lines and revenues, plus data for all other interexchange carriers combined.³²

³¹ Based on results of analysis of data for 1996 from "Bill Harvesting III" Release 2, *op. cit.*.

³² Joe Bender, "Long Distance Market Shares," *op. cit.* Of the interexchange carriers for which the FCC reports both presubscribed lines and operating revenues, I have selected the ten carriers with the largest number of presubscribed lines. Had I selected the largest carriers based on their revenues, that selection process would have introduced a bias toward displaying carriers which have high revenue per line relative to AT&T. Since I have selected the carriers with the largest number of lines, I avoid that selection bias. One should use these data with caution. The data for revenues might not be fully comparable to the data for presubscribed lines and might not be defined in the same way by different carriers. One should use special caution regarding the revenue figure for "all others," since it is calculated as a residual from the figure for total revenues, which the FCC staff has estimated.

Table 3
Revenue per Presubscribed Line

	Presubscribed Lines in June 1996	Revenue (M) in 1996	Revenue per Line in 1996
AT&T	99,821,499	\$39,264	\$393.34
MCI	24,338,086	\$16,372	\$672.69
Sprint	10,905,940	\$7,944	\$728.41
WorldCom	4,288,401	\$4,485	\$1,045.84
Excel Telecommunications	3,313,287	\$1,091	\$329.28
Frontier companies	2,097,182	\$1,563	\$745.29
LCI	1,965,532	\$1,103	\$561.17
Cable & Wireless	584,802	\$919	\$1,571.47
U.S. Long Distance	356,932	\$188	\$526.71
Business Telecom	171,239	\$149	\$870.13
Vartec Telecom	116,898	\$470	\$4,020.60
General Communications	124,969	\$143	\$1,144.28
All others	<u>3,996,101</u>	<u>\$8,342</u>	<u>\$2,087.53</u>
Total	152,080,868	\$82,033	\$539.40

27. What we see in the last column is that all the carriers except one have higher revenues per presubscribed line than AT&T does. The only exception is Excel Telecommunications, which, according to the FCC report, is a pure reseller and which is only about two percent of AT&T's size. The lesson is that the carriers other than AT&T tend more to focus on high-volume customers than AT&T does.

28. This pattern is not surprising, since interexchange carriers bear some fixed costs per customer. Such fixed costs include a fee paid to a local exchange carrier for processing a presubscription order and some of the costs of marketing, customer care, and perhaps some billing costs. To some extent the latter three types of costs increase with a customer's volume of usage, but there is a fixed component, too. Thus, since the low-usage segment is more costly to acquire and serve relative to the revenues it generates, it is not as profitable a segment to pursue aggressively. As I explain in Section VI below, the low-volume market segment should be less costly for BellSouth to serve than it is for other existing interexchange carriers, so BellSouth's entry holds out the prospect of more intensified competition for this segment and